

Internal Revenue Service

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Person To Contact:

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CC:PSI:B1

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Date:

June 23, 2006

Legend

X =

State =

J =

K =

L =

M =

N =

LLC =

a =

b =

c =

d =

e =

f =

Date 1 =

Date 2 =

Date 3 =

\$x =

\$y =

Dear :

This letter responds to a letter dated December 6, 2005, submitted on behalf of X by X's authorized representative, requesting a ruling that X's rental income from various properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i).

The information submitted states that X was incorporated in State on Date 1. X has elected to be treated as an S corporation effective Date 2.

X represents that X owns properties that are rented to tenants. X also owns an interest in several entities, all of which are treated as partnerships for federal tax purposes and are in the business of renting real property to tenants: X is the general partner in J, a State law general partnership; X owns an interest in K, L, and M, all of which are joint ventures; and X owns an interest in LLC. X also has an ownership interest in N, property held in tenancy in common. X represents that it is responsible for managing the properties it owns directly, as well as the properties owned by J, K, L, M, N, and LLC (collectively, "the Properties").

As of Date 3, X represents the following: X directly owns a. J owns b. K currently owns no properties. L owns c. M owns d. LLC owns e.

X has approximately f employees. X represents that it provides various services to the tenants of the Properties. Services provided by X include but are not limited to, the following: repair and maintenance of roof, foundation, exterior walls, gutters, downspouts, plumbing, fire sprinkler, electrical, heating, ventilation and air conditioning systems; responsibility for landscaping, lawn and paved area maintenance and snow removal. X also oversees compliance with fire and insurance regulations, arranges for cleaning and repair of vacant properties. In addition, X arranges for leasing vacant properties, negotiates all leases and mediates disputes, and hires a managing agent to provide management services under the leases.

In the taxable year ending Date 3, X received or accrued approximately \$x in rents, which includes reimbursements by tenants for insurance, property taxes,

expenses for maintaining common areas and promotional fees paid by X. X paid or incurred approximately \$y in relevant expenses other than depreciation.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(3)(A) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

Section 1362(d)(3)(C)(i) provides that except as otherwise provided, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(2) of the Income Tax Regulations provides that "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Based solely on the facts and the representations submitted we conclude that the rental income that X derives from the Properties is not passive investment income as described in § 1362(d)(3)(C)(i).

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Specifically, we express no opinion on whether X is a small business corporation eligible to make an S election. Further, the passive investment income rules of § 1362 are completely independent of the passive activity rules of section § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Audrey W. Ellis
Senior Counsel, Branch 1
Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy for 6110 purposes

cc: